UNITED STATES TAX COURT

THE BANK OF NEW YORK MELLON CORPORATION, AS SUCCESSOR IN INTEREST TO THE BANK OF NEW YORK COMPANY, INC.	)	
Petitioner,	)	
v.	)	**Docket No. 26683-09**
COMMISSIONER OF INTERNAL REVENUE,	)	**Judge Kroupa**
	)	**Special Trial Session**
Respondent	)	**April 16, 2012**

PETITIONER'S PRETRIAL MEMORANDUM

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PETITIONER'S PRETRIAL MEMORANDUM

I. Attorneys for Petitioner

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II. Amount in Dispute

Respondent determined a deficiency in Federal income taxes of $100,489,534 for Petitioner's[1] taxable year ended December 31, 2001 (the "2001 Tax Year"), and $114,978,105 for Petitioner's taxable year ended December 31, 2002 (the "2002 Tax Year"). Petitioner disputed those adjustments in the amounts of $100,310,840 for the 2001 Tax Year and $113,665,397 for the 2002 Tax Year in the petition. The BNY STARS Transaction at issue in this docket is also disputed in later years (2003, 2004, 2005, and 2006 taxable years).

No additions to tax are asserted.

III. Status of Case

Trial begins April 16, 2012.

[1] Petitioner The Bank of New York Mellon Corporation is successor in interest to The Bank of New York Company, Inc. ("BNY Parent"), which was the common parent of an affiliated group of corporations ("BNY") for all relevant periods.

IV. Current Estimate of Trial Time

Two to three weeks.

V. Pending and Expected Motions

On March 26, 2012, Petitioner filed a motion to exclude the rebuttal testimony of Respondent's expert Edward Cipullo. Petitioner expects to file within the next week motions to exclude expert testimony of Michael Cragg and to quash trial subpoenas of a number of unnecessary witnesses. Petitioner may move for a protective order with respect to privileged information known to certain attorneys whom Respondent has subpoenaed for trial. The need to file some of these motions may depend on the content of Respondent's pretrial memorandum to be submitted today, so Petitioner cannot yet confirm the precise content of those motions. Petitioner also expects to file a motion to exclude certain stipulations and documents on relevance grounds.

VI. Evidentiary Issues

Other than evidentiary issues arising from the motions described above, the only other evidentiary issue of which Petitioner is currently aware is that hearsay objections have been reserved for certain documents authenticated in the Revised Stipulations of Facts[2] and authenticity objections have been reserved for six documents.

[2] See infra Section VII for a discussion of the status of the Stipulations.

VII. Status of Stipulations of Facts

The parties lodged a Stipulation of Facts with the Court on November 21, 2011, replaced by amended Stipulation of Facts lodged with the Court on December 12, 2011. A further Revised Stipulation of Facts was lodged by the Office of the Clerk of the Court as the "Second Amended Stipulation of Facts" on January 19, 2012. The parties intend to lodge supplemental Stipulations of Facts with the Court prior to trial. All stipulations are numbered with continuously successive paragraphs and cited herein as "Stip. ¶."

VIII. Issues

The parties dispute whether Petitioner is entitled to U.S. foreign tax credits for income taxes owed and paid to the United Kingdom ("U.K."). The U.K. income taxes were owed and paid on income from Petitioner's assets held in a trust created to obtain the use of $1.5 billion from Barclays Bank, PLC ("Barclays") for five years at a very favorable rate beginning in November 2001. Petitioner used the funds from Barclays in a core banking business activity: improving its net interest income. To obtain the financing from Barclays, Barclays required that Petitioner hold income-producing assets in the form of a structure that Barclays designed.

Respondent has not challenged Petitioner's entitlement to foreign tax credits for these taxes under any technical provision of the Internal Revenue Code of 1986, as amended (the

"Code"), or regulations promulgated thereunder. Rather, Respondent's position is based on claims that the transaction between Petitioner and Barclays that provided the low-cost financing to Petitioner (the "BNY STARS Transaction") lacks economic substance and a business purpose and is a sham (or that section 269 applies to certain aspects of the BNY STARS Transaction). In doing so, Respondent advances the novel argument that, even though the BNY STARS Transaction was expected to be profitable, pre-tax, and in fact was profitable pre-tax, and had a business purpose of providing low-cost funding, Petitioner should have borrowed at a higher rate in a conventional, unstructured borrowing. Respondent's position lacks a basis in law or fact and cannot be sustained.

Alternative arguments will be addressed in post-trial briefs; they are not necessary to a contemporaneous understanding of the evidence that will be presented at trial. Respondent also made other erroneous adjustments on Petitioner's tax returns for the 2001 and 2002 Tax Years based on his erroneous view of the transaction. Those too will be addressed in post-trial briefs.

IX. Witnesses Petitioner May Call

Petitioner may present the following testimony in its case in chief. The witnesses below may also testify about other topics raised by Respondent to the extent the Court deems those matters relevant. Depending on Respondent's presentation,

Petitioner may call these or other witnesses in rebuttal. Petitioner reserves the right to call any witness identified by Respondent in his pretrial memorandum.

Witness	Expected Testimony
Thomas (Todd) Gibbons	Mr. Gibbons was Chief Risk Officer of the Bank of New York ("BNY Bank") at the time the BNY STARS Transaction was considered by Petitioner. He is now Chief Financial Officer. He may testify as to BNY Bank's sources and uses of funds and business activities.
Thomas Price	Mr. Price was Treasurer of BNY Bank when the BNY STARS Transaction was considered, negotiated, and closed. He may testify as to BNY Bank's sources and uses of funds and its business strategy and to how the loan from Barclays made by means of the BNY STARS Transaction fit with BNY Bank's business objectives and activities.
Thomas Mastro	Mr. Mastro was Comptroller of BNY Bank at the time of the BNY STARS Transaction. He may testify as to the anticipated impact of the BNY STARS Transaction on BNY Bank's net interest income.
Gerard Colaluca	Mr. Colaluca was a Vice President in BNY Bank's Treasury Department and head of BNY Bank's "Strategic Solutions Group" ("SSG") and as such was responsible for the execution of the BNY STARS Transaction. He may testify as to Petitioner's consideration, negotiation and execution of the BNY STARS Transaction.

Witness	Expected Testimony
Robert Brady	Mr. Brady was a Vice President in BNY Bank's Treasury Department and a member of SSG and worked on executing the BNY STARS Transaction. He may testify as to the execution of the transaction and also as to the operation of the formulas in the transactional documents that calculated the payments between the parties.
John DeRosa	Mr. DeRosa was Senior Vice President, Tax at BNY Bank at the time of consideration and negotiation of the BNY STARS Transaction. He may testify as to the consideration and negotiation of the BNY STARS Transaction.
Monique Lipton	Ms. Lipton was Assistant Tax Director at the time of the negotiation and execution of the BNY STARS Transaction and later acting Tax Director. She may testify as to the execution of the BNY STARS Transaction.
David England	Mr. England was a director and Chief Executive Officer of the U.K. Trustee of the Trust during all relevant periods. He will testify (via designated videorecorded passages from a deposition to preserve testimony) to the activities of the U.K. Trustee generally and to the U.K. Trustee's performance of its responsibilities as trustee of the Trust.

Witness	Expected Testimony
Iain Abrahams	Mr. Abrahams was a senior employee of Barclays, the counterparty in the BNY STARS Transaction providing the low-cost funding to Petitioner. He may testify as to Barclays' development of the STARS structure (including the role of U.K. tax considerations of various components); the role of U.K. taxes in the BNY STARS Transaction; and Barclays' views of the BNY STARS Transaction.
Sohail Sultan	Mr. Sultan was an employee of Barclays, the counterparty in the BNY STARS Transaction providing the low-cost funding to BNY. He will testify (via designated videorecorded passages from a deposition to preserve testimony) as to Barclays' development of the STARS structure (including the role of U.K. tax considerations of various components); the role of U.K. taxes in the BNY STARS Transaction; and Barclays' views of the BNY STARS Transaction.
Alkis Ioannidis	Mr. Ioannidis was an employee of Barclays, the counterparty in the BNY STARS Transaction providing the low-cost funding to BNY. He will testify (via designated videorecorded passages from a deposition to preserve testimony) as to Barclays' development of the STARS structure (including the role of U.K. tax considerations of various components); the role of U.K. taxes in the BNY STARS Transaction; and Barclays' views of the BNY STARS Transaction.

Witness	Expected Testimony
Kevin Glenn	Mr. Glenn was at all relevant times an employee of KPMG LLP ("KPMG") and advised BNY Bank on the BNY STARS Transaction. Mr. Glenn may testify as to the negotiations concerning the BNY STARS Transaction and the ultimate features of the transaction as executed.
Craig Chapman	Mr. Chapman was a partner at Sidley Austin Brown & Wood ("Sidley") at the time of the introduction of the BNY STARS Transaction and the negotiations between BNY Bank and Barclays and served as corporate counsel for BNY Bank in the negotiations. He may testify regarding Sidley's role at the beginning of the BNY STARS Transaction and describe the negotiations with Barclays regarding the terms of the BNY STARS Transaction.

Expert Witness	Testimony
W. Clifford Atherton, Jr., Ph.D.	Dr. Atherton will testify to the expected pre-tax profit to Petitioner from the BNY STARS Transaction. His case-in-chief Expert Testimony was lodged with the Court on December 21, 2011, and his rebuttal Expert Testimony was lodged with the Court on February 1, 2012.
Gerald Hanweck, Sr., Ph.D.	Dr. Hanweck will testify as to the banking business generally, the sources for and uses of funds by banks, and how the BNY STARS Transaction fit in this business activity. His case-in-chief Expert Testimony was lodged with the Court on December 21, 2011, and his rebuttal Expert Testimony was lodged with the Court on February 1, 2012.
Michael Brindle QC	Mr. Brindle will testify as to the treatment of the Trust under U.K. regulatory law as a "collective investment scheme" and therefore a "unit trust scheme" that was not authorized under that law (and therefore was an "unauthorized unit trust"). His case-in-chief Expert Testimony was lodged with the Court on December 21, 2011.
Julian Ghosh QC	Mr. Ghosh will testify to the U.K. tax treatment of the Trust and the unit holders in the Trust. His case-in-chief Expert Testimony was lodged with the Court on December 21, 2011, and his rebuttal Expert Testimony was lodged with the Court on February 1, 2012.

X. Summary of Facts

A. Overview

Respondent has challenged Petitioner's entitlement to U.S. foreign tax credits for income taxes owed and paid to the U.K.

Petitioner borrowed $1.5 billion from Barclays in November 2001. As Petitioner had expected to do at the time the transaction closed, Petitioner used the borrowed funds in a core business activity for five years.

The form of the financing was complicated. The form was required by Barclays, not by Petitioner. By lending to Petitioner through the structure that Barclays designed, Barclays could offer a very favorable borrowing rate. In the Stipulations, this structure is referred to as the "BNY STARS Transaction."

Barclays required Petitioner to transfer assets that produced income to a trust that would have a U.K. trustee so that the U.K. trustee, as a U.K. resident, would owe and pay U.K. income tax on that income. Of course, from Petitioner's perspective, Petitioner wanted a favorable borrowing rate but did not want to pay taxes twice on the same income. As between the U.S. and the U.K., Petitioner was neutral as to whom it paid its income tax; it just wanted to avoid being double-taxed.

The Code taxes U.S. corporations on worldwide income and then credits the foreign income taxes owed and paid (subject to

complicated rules and limitations) against the U.S. Federal income tax liability on that same income. The Congressional policy underlying the foreign tax credit is to reduce the incidence of double taxation. None of the Code's foreign tax credit rules or limitations or the implementing regulations is at issue here; Petitioner's claim of foreign tax credits for the U.K. income taxes met all of the requirements of the Code and regulations.

In the BNY STARS Transaction, Barclays deposited $1.5 billion with Petitioner. Both counterparties expected Petitioner to use the borrowed funds for five years at a floating cost that was more than three percentage points (300 basis points) below the monthly U.S. dollar LIBOR rate.[4] Barclays offered Petitioner this low-cost financing because Barclays expected to receive from the structure it designed at least twice the value of the reduced borrowing rate, before taking into account the reduced borrowing costs Barclays offered Petitioner.

[4] A floating rate adjusts with a market benchmark, in this case monthly U.S. dollar London Inter-Bank Offered Rate ("LIBOR"). LIBOR is a published rate that is offered for overnight, one-month, three-month, six-month and one-year borrowings.

As it had anticipated, Petitioner used these low-cost funds in Petitioner's banking business for five years. As Petitioner expected, the low-cost financing generated positive, pre-tax net income in a core banking business activity, i.e., improving its net interest income. Accordingly, Petitioner earned income on the spread between the low cost of the borrowed funds and the yield from investing the $1.5 billion of funds from Barclays in its business.

B. Structure of the BNY STARS Transaction

Petitioner is the successor institution to BNY Bank, a prominent U.S. banking institution with a long history and worldwide operations, including a branch office in the U.K. See Stip. ¶¶ 223-224.

The Court will hear testimony on the complicated form of the BNY STARS Transaction. The complication was required by Barclays' U.K. tax objectives, not BNY Bank. In essence, the complicated form should not be confused with the simplicity of the BNY STARS Transaction's effect on BNY Bank's business activity: BNY Bank's use of $1.5 billion for five years at LIBOR less 300 basis points, an enormously beneficial rate for BNY Bank's business.

Barclays deposited funds with BNY Bank subject to BNY Bank's obligation to repay the same amount not more than five years later. As contemplated by both counterparties (Barclays

and BNY Bank), BNY Bank repaid the deposit to Barclays at the end of five years.[5] Barclays, in viewing this as the loan it was, assessed BNY's credit risk, took the (five-year) loan to two levels of internal credit committees, and obtained credit support for BNY Bank's repayment obligations.

Barclays could lend BNY Bank such low-cost funding because of the benefits to Barclays under pertinent U.K. law. To accomplish its objectives, Barclays designed a structure under U.K. law that enabled it to report income that, for U.S. Federal income tax purposes, belonged to BNY Bank. It is this structure, designed for Barclays' U.K. tax benefit, that introduces complexity. In designing the form of the transaction, Barclays understood that a U.S. taxpayer would not enter the transaction if it were subject to double taxation. Accordingly, in designing the financing structure, Barclays consulted with KPMG to ensure that the U.S. tax consequences of the arrangement did not result in double taxation (U.S. and U.K.).

Barclays proposed lending the funds to BNY Bank through a unit trust (the "Trust") in which both counterparties held units representing ownership for U.K. tax and regulatory law purposes.

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[5] The deal documents in the BNY STARS Transaction permitted either counterparty to terminate the financing on short notice, but this was not expected to occur so long as it was in both counterparties' economic interests to continue the financing to term. See Stip. ¶ 80. The financing lasted five years as expected from the outset.

BNY Bank transferred assets to the Trust in exchange for Class A Units and a Class B Unit. Barclays transferred $1.5 billion in exchange for a Class C Unit and a Class D Unit.[6] The Trust immediately redeemed BNY Bank's Class B Unit for $1.5 billion. Repayment of the loan to Barclays was fixed by BNY Bank's obligation under forward sale agreements[7] to acquire Barclays' Class C Unit and Class D Unit in five years for the same $1.5 billion.

The Trust held shares in a BNY Bank subsidiary, DelCo,[8] which owned income producing assets. For U.S. Federal income tax purposes, Petitioner continued to earn and report the income from DelCo's assets and from other income producing assets held by the Trust. Approximately $2.25 billion of DelCo and Trust

[6] BNY subsidiaries (BNY Investment Holdings (DE), Inc. ("InvestCo") and BNY NewCo Funding (DE), LLC ("NewCo")) contributed the stock of BNY Delaware Funding (DE) LLC ("DelCo") and some mortgage backed securities to the Trust in exchange for ownership units in the Trust (Class A Units and Class B Unit). Barclays acquired the Class C Unit and the Class D Unit in the Trust by transferring $1.494 billion to the trustee. See Stip. ¶ 45. $1.494 billion was net of the $6 million fee retained by Barclays to pay KPMG its agreed fee. The Class B Unit was redeemed for the $1.494 billion that Barclays had paid to subscribe for its units in the Trust. Thus, $1.494 billion from Barclays was transferred to InvestCo and on to BNY Bank and $6 million was paid to KPMG, for a total financing amount of $1.5 billion.

[7] A forward sale agreement is commonly used in finance and is an agreement that obligates a party to sell a specified asset at a future date for a set price.

[8] BNY Bank transferred $7.8 billion of its income producing assets to DelCo in the BNY STARS Transaction.

assets were pledged as security for the repayment of the $1.5 billion to Barclays.[9]

Under the structure, Barclays required actual distributions on its Class C Unit. The exact amount of each distribution was required to be recontributed to the Trust by means of a blocked account and was treated as a further subscription payment on the Class C Unit. The blocked account mechanism assured that every Class C Unit distribution was immediately contributed back to the Trust. This preserved the form that Barclays believed it needed for its U.K. tax benefits while preserving BNY Bank's economic ownership of the income. Of course, under U.S. Federal income tax law the circularity of funds was disregarded, and the income was reported by Petitioner, as noted above.

The Class D Unit distributions were not subject to this mandatory recontribution arrangement and were retained by Barclays. The Class D Unit distributions were treated as interest paid on the deposit for U.S. Federal income tax law purposes.

[9] BNY Bank agreed to hold not less than this amount in collateral accounts for so long as Barclays held the Class C Unit. See Stip. ¶ 93. Because the value of the assets was greater than the face amount of the Barclays deposit, the deposit was "overcollateralized". Overcollateralization is common in financing; for example, a home with a 20 percent downpayment is overcollateralized.

C. U.K. Tax Treatment of Trustee

The DelCo dividends and other income on the assets held by the Trust were subject to tax in the U.K. for the purposes of the relevant U.S.-U.K. treaty provisions because a U.K. resident entity, The Bank of New York Trust and Depositary Company Limited (the "U.K. Trustee"), was trustee of the Trust. See Stip. ¶¶ 35, 142, 144, 176-177, 181.

The Trust was taxed under U.K. income tax law as a "collective investment scheme" that was regarded under U.K. law as an "unauthorized unit trust" ("UUT"). A UUT is an investment fund that is unauthorized to sell units to the public. As the Trust was a UUT, the U.K. Trustee owed and paid U.K. income tax at a 22 percent rate on dividends that Delco paid to the Trust and also any other income arising to the Trust.

D. U.K. Tax Treatment of Barclays

In accordance with U.K. law and the structure, Barclays was obligated to, and did, report 99 percent of the distributable income of the Trust (all but that attributable to Petitioner's Class A Units) grossed up by 22 percent ("deemed annual payments").[10] Unit holders were required to report deemed annual payments, whether the Trust made any distributions or not.

[10] The amount of the deemed annual payments was equal to the unit holder's share of distributable income (after the trustee's payment of tax), grossed up by 22 percent. So if a particular unit holder's share of distributable trust income was 78, then

Separate from the income tax owed by the Trustee, Barclays as a unit holder owed U.K. corporate tax on those deemed annual payments at a 30 percent rate (less certain deductions).

The U.K. law entitled Barclays, as the holder under U.K. regulatory and tax law of the Class C Unit and the Class D Unit, to claim a credit equal in amount to the U.K. income tax owed by the U.K. Trustee, in proportion to Barclays' ownership interest. This credit was available whether income from the Trust was distributed or not, and whether or not the U.K. Trustee paid its tax liability.

To achieve the intended U.K. tax treatment, Barclays required that the U.K. Trustee make a minimum amount of actual distributions on the Class C Unit, see Stip. ¶¶ 35, 144, which went into the blocked account as described above. Barclays then recontributed those amounts to the Trust. Because of the fixed price under the forward sale agreement to acquire the Class C Unit, Barclays could claim current deductions under U.K. law for the amounts of those recontributions.

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the unit holder was deemed to have received a payment of 100 (78 plus 22).

[12] The parties also entered into a credit default swap under which Barclays paid Petitioner 10 basis points on a notional amount of $1.475 billion. The credit default swap between BNY Bank and Barclays had the effect of guaranteeing the performance of InvestCo. Before that arrangement was agreed to, the benchmark cost of funds in the draft zero coupon swap documents had been LIBOR plus 20 basis points. The difference is immaterial to an understanding of the structure.

Barclays mostly offset its income arising from the deemed annual payments with these current deductions because U.K. law regarded these amounts as further additions to the cost of the Class C Unit. These deductions were a critical element of Barclays' anticipated U.K. tax treatment. Economically, the deductions covered enough of Barclays' income that the credit arising from the trust structure was then available to Barclays for other purposes and left Barclays with a net U.K. income tax benefit.

Because of the structure, Barclays could confer upon BNY Bank half the value of Barclays' anticipated U.K. income tax benefits.

E. The Cost of Funds in the BNY STARS Transaction

BNY Bank's cost of funds on the $1.5 billion borrowed from Barclays was determined by reference to the values of the Class C Unit and the Class D Unit held by Barclays. Because Barclays did not receive any return on its Class C Unit, the payment from BNY Bank to Barclays was determined under a zero coupon swap between InvestCo and Barclays. The zero coupon swap was based on the value of Barclays' Class C Unit ($1.475 billion). The counterparties agreed to monthly payments on the Class C Unit value of $1.475 billion as required by a formula based on monthly LIBOR plus 30 basis points less half the expected value of Barclays' U.K. tax benefits from the structure. Payments on

the value of the $25 million Class D Unit were determined by monthly LIBOR.

Over the life of the BNY STARS Transaction, the negotiated agreement resulted in an effective cost of funds to BNY Bank of U.S. dollar LIBOR minus approximately 300 basis points. When LIBOR dropped low enough, the formula payment on the Class C Unit value under the zero coupon swap required Barclays to pay BNY Bank.

F. Repaying the Loan

BNY Bank was obligated to repay Barclays the borrowed $1.5 billion by means of two forward sale agreements. Under the forward sale agreements, BNY Bank, through InvestCo, was obligated to acquire from Barclays the Class C Unit and Class D Unit in the Trust that Barclays held for a total of $1.5 billion. [12] The purchase price of the Class C Unit was $1.475 billion.[13] The purchase price of the Class D Unit was $25 million. See Stip. ¶¶ 65-68, 71-73, 77. In November 2006, InvestCo acquired the Class C Unit from Barclays in exchange for $1.475 billion, and in December 2006, InvestCo acquired the Class D Unit from Barclays for $25 million. See Stip. ¶¶ 173-174. Thus, through InvestCo, BNY Bank repaid the deposit to Barclays at the end of five years, as expected.

[13] After netting against the fixed leg of the zero coupon swap.

In sum, for U.S. tax purposes, in substance, Barclays never owned the C units. Barclays was required to recontribute all actual income on the Class C Unit (received via distributions to the blocked account), and Barclays sold the Class C Unit back to BNY Bank at a fixed price with an interest component. Thus, all of the value in the Trust (except for income on the Class D Unit) went to BNY Bank. Barclays' role for U.S. purposes was solely to lend money to BNY Bank.

G. Stripping Transaction

In December 2001, the counterparties entered into a stripping transaction in which the Trust sold interest only certificates ("IOs") to DelCo. The transaction was subject to immediate U.K. tax on the entire consideration paid for the IOs, giving rise to an additional expected U.K. tax benefit to Barclays in December 2001. This stripping transaction was anticipated by the terms of the zero coupon swap executed the month before, which for 13 months, from December 2001 through December 2002, reduced the funding costs of the $1.5 billion by an additional amount equal to half of the value of its additional expected U.K. tax benefit. The stripping transaction had the effect of accelerating expected U.K. tax benefits to Barclays and commensurately accelerating the economic benefit to BNY of the BNY STARS Transaction.

H. U.S. Tax Reporting by BNY Bank

Petitioner was subject to U.S. income tax on the DelCo dividends and other income on the assets held by the Trust (except for the small share attributable to the Class D unit). Petitioner reflected the U.K. income tax payments made by the U.K. Trustee as foreign tax credits against its U.S. income tax liability, so that its global tax liability on the Trust's income was not increased as a result of the BNY STARS Transaction.

XI. Synopsis of Legal Authorities

A. Introduction and Overview

Section 901 of the Code permits taxpayers to reduce the taxes that they owe the United States by the amount of taxes that they pay to a foreign sovereign on the same income. By alleviating double taxation, the foreign tax credit ensures that U.S. taxpayers are not disadvantaged when their business or investment activities in other jurisdictions give rise to income tax in those other jurisdictions. The role of section 901 foreign tax credits in this case is precisely this alleviation of double taxation. BNY Bank had to ensure that the U.S. tax rules worked as expected so that the bank would not be subject to double taxation. Otherwise, U.S. federal income taxes played no role.

Petitioner and Respondent have stipulated to all the material details concerning the BNY STARS Transaction, including facts showing that Petitioner had use of $1.5 billion for five years, that Barclays provided this funding, and that Petitioner repaid Barclays at the end of the five years.

Respondent stipulated that U.K. income taxes were paid to Her Majesty's Revenue and Customs ("HMRC")[14] on the income earned by the assets held in the Trust. See Stip. ¶ 181. Respondent has not challenged the foreign tax credits for these U.K. taxes on any technical grounds. Recognizing the futility of any such technical challenges, Respondent instead seeks to persuade this Court to accept mutations of the common law doctrines.

Respondent's sole basis for challenge is an allegation under U.S. federal income tax common law that the U.K. Trust through which Barclays provided the low-cost funding was a sham, and the transaction lacked economic substance and business purpose. Respondent's position derogates decades of caselaw. BNY Bank borrowed $1.5 billion from Barclays that it used in its banking business for five years. Further, BNY Bank could not have borrowed $1.5 billion from Barclays for five years unless BNY Bank entered the form of the BNY STARS Transaction as designed by Barclays. If that is not real economic activity

[14] The U.K. taxing authority was Inland Revenue prior to April 18, 2005, and HMRC from April 18, 2005 onward. For purposes of this case they are referred to together as HMRC.

with a substantial non-tax business purpose, Respondent could whimsically disregard any business activity he dislikes.

Respondent's attacks amount to emotionally laden code words because he cannot seriously challenge the merits of Petitioner's Federal income tax reporting position. His position may make a sweet sound bite, but it sours in the light of precedent.

Respondent is attempting to stretch fundamental common law doctrines beyond recognition. The BNY STARS Transaction was a real financing transaction between unrelated counterparties acting at arm's length with clear economic objectives and consequences for the counterparties and that was expected to, and did, result in a pre-tax profit to BNY Bank.

B. The Economic Substance of the BNY STARS Transaction

The common-law economic substance doctrine, as articulated by the main Second Circuit authority, Goldstein v. Commissioner, 364 F.2d 734, 740 (2d Cir. 1966), disregards a transaction as lacking economic substance if it "can not with reason be said to have purpose, substance, or utility apart from [its] anticipated tax consequences". See also Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004), aff'd by summary opinion, 96 A.F.T.R.2d 2005-6344 (2d Cir. 2005).

The analysis often is separated into two inquiries: (i) whether the transaction had substantial non-tax economic effects (often referred to as the objective "economic substance" test) and (ii) whether the transaction had a substantial non-tax

business purpose (often referred to as the subjective "business purpose" test). Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91-92 (4th Cir. 1985). The Second Circuit has adopted a flexible test that considers both of these factors. Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991).

1. Pre-Tax Profit

Under the objective economic substance prong, the transaction "will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits." Gilman v. Commissioner, 58 T.C.M. (CCH) 1075, 1080 (1989) (quoting Gefen v. Commissioner, 87 T.C. 1471, 1490 (1986)), aff'd, 933 F.2d 143 (2d Cir. 1991). The "pre-tax profit" test asks the Court to look at the profit from the transaction without regard to tax benefits and "evaluate the transaction on its merits." In re CM Holdings, 301 F.3d 96, 105 (3d Cir. 2002). The test is designed to determine whether, prior to paying taxes and taking deductions or claiming credits, the transaction was profitable.

In the BNY STARS Transaction, the income earned by the Trust was taxable in the U.K. because, under U.K. law, the U.K. Trustee, who bore the liability for U.K. taxes on income generated by assets held by the Trust, was a U.K. resident. Under the 1980 U.S.-U.K. Treaty,[15] which was applicable here, the

[15] The Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and

U.S. ceded to the U.K. primary taxing jurisdiction on income taxed in the U.K. – because it was earned by taxpayers considered under U.K. law to be U.K. residents – and granted U.S. taxpayers a credit for such taxes paid. Further, to the extent such income would otherwise be U.S. source in the absence of the treaty (as was the case here), the 1980 U.S.-U.K. Treaty determined the income to be foreign source income to ensure that the foreign tax credit limitation rules in section 904 would operate to avoid double taxation on the same income.

Claiming the disputed foreign tax credits did not cause Petitioner to reduce its worldwide taxes on the income of the Trust. To the contrary, because Petitioner reduced its financing costs and invested the new funds obtained from Barclays in additional income producing assets, Petitioner increased its taxable income by the spread between those two amounts and, therefore, the global income taxes it paid on all income relating to the BNY STARS Transaction.

Petitioner's expert witness, Dr. Atherton, concluded that Petitioner reasonably could have expected a profit of more than $1.6 billion before taking into account U.K. or U.S. income taxes over the life of the BNY STARS Transaction. Dr. Atherton also concluded that even if foreign taxes are treated as an

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Capital Gains, U.S.-U.K., Dec. 31, 1975, 31 U.S.T. 5668 (entered into force Apr. 25, 1980).

expense, Petitioner reasonably could have expected a profit of more than $1 billion over the life of the BNY STARS Transaction.

In stark contrast, Respondent's experts assert that the BNY STARS Transaction does not generate *any* pre-tax profit because they improperly measure pre-tax profit not as it relates to the actual transaction but against a hypothetical benchmark. Specifically, they concoct an alternative arrangement that no one transacted, and allege that Petitioner incurred a "loss" because its real profit was not as great as the identified hypothetical alternative profit. Their approach is the equivalent of believing that because a person could have purchased Apple Inc. stock a year ago at $100 per share, but failed to purchase it, the person has a loss because Apple is now trading at $600 per share.

Furthermore, Respondent's experts' own calculations show that the BNY STARS Transaction generated a large pre-tax profit, as that phrase is universally understood in the caselaw, even if the profit is not so labeled in those reports.[16] Respondent's experts sidestep these indisputable pre-tax profit figures in their own reports by (i) ignoring the transaction the counterparties actually negotiated and entered; (ii) bifurcating the actual BNY STARS Transaction into two fictional parts, neither of which is plausible; (iii) allocating cash flows to

[16] See Dr. Atherton's rebuttal report to the Testimony of David J. Ross at 6—8; and Dr. Atherton's rebuttal report to the Testimony of Michael I. Cragg at 9-11.

the bifurcated parts in a manner inconsistent with both counterparties' understanding of the transaction and the transaction documents; (iv) hypothesizing a transaction that neither party engaged in; and (v) comparing only part of the fictional allocation of cash flows to Respondent's experts' fancied hypothetical. Not only does this analysis bear no relationship to the facts of the BNY STARS Transaction, it has no basis in jurisprudence of this Court, the Second Circuit or the other Circuits. Respondent may wish that his experts' approach was the law, and he has invested substantially in their pursuit of this theory, but there is no support for this novel and nonsensical approach.

One of Respondent's experts, Mr. Ross, takes the even more remarkable position that Petitioner is not entitled to the foreign tax credit because the total U.K. taxes paid by both counterparties did not increase by an amount equal to the foreign tax credit claimed by Petitioner. This perspective requires a taxpayer to look at the net tax payments made by multiple, unrelated parties to a foreign government under foreign law to determine the pre-tax profitability for U.S. tax purposes to a single party to that transaction. Respondent cites no authority for this ridiculous requirement, because there can be none. Mr. Ross' apparent legal conclusion that Petitioner is not entitled to the foreign tax credits is

unhinged from any analysis of whether the BNY STARS Transaction was profitable on a pre-tax basis for Petitioner.

The Code has long recognized that two different sovereigns may tax different income bases at different times and in different amounts. By contrast to Mr. Ross' arguments, in very common transactions a tax paid on income of one taxpayer yields a deduction and an equivalent reduction in tax for a second taxpayer. The Code does not, and could not, require a dollar for dollar match between the tax ultimately received by the foreign sovereign from all parties to a transaction and the foreign tax credit claimed by the U.S. taxpayer. Taxpayers could not possibly know, expect to know, or be required to know the foreign tax position of their foreign counterparty. Respondent appeals to revisionistic common law standards that do not exist. The BNY STARS Transaction was reasonably expected to, and did, generate a pre-tax profit under any formula that now exists in the law. The Court should not countenance such an end-run around the real common law doctrines.

2. Business purpose

The comprehensive Stipulations the parties have lodged with the Court and evidence at trial will demonstrate that Petitioner entered into the BNY STARS Transaction to borrow low-cost funds that it used in its banking business. The evidence also will prove that Barclays made this low-cost funding available because Barclays believed it would receive a U.K. tax benefit by

structuring the financing through a U.K. trust subject to special U.K. tax rules.

The evidence will show that the BNY STARS Transaction provided funding to Petitioner at more than 300 basis points below LIBOR. Petitioner uses funding in a core banking business activity to invest in loans and securities and earns a profit on the spread between the return on its investments and the cost of its funding. In the banking business, this spread is known as "net interest income." See Stip. ¶¶ 228-229. In addition to the benefit that the low-cost funding of $1.5 billion at approximately LIBOR minus 300 basis points brought to a core banking business activity, in 2001 Petitioner also was expanding its investments in asset-backed securities, and a $1.5 billion low-cost, five-year source of funding facilitated Petitioner's objective to move its asset mix into asset-backed securities.

Respondent alleges that U.S. tax considerations motivated Petitioner to enter into the BNY STARS Transaction because Petitioner would not have entered into the BNY STARS Transaction if the foreign tax credits were not available. This distorts both the facts and the applicable legal standards. First, as the evidence will show, Petitioner entered into the BNY STARS Transaction primarily to obtain low-cost funding.[17] The foreign tax credits resulting from the BNY STARS Transaction served the

[17] Other related business objectives included having use of the funds for five years.

reason that Congress provided foreign tax credits for taxpayers – to alleviate the double taxation that Respondent seeks to impose here. Petitioner would not pay less income tax worldwide by obtaining this funding from Barclays than Petitioner would have paid had Petitioner obtained funding from a U.S. lender. Second, as the testimony also will show, the only way Barclays was willing to offer the below-LIBOR funding to Petitioner was if Petitioner engaged in the BNY STARS Transaction. The foreign tax credits were necessary to prevent double taxation, but they were not a motivation for the transaction any more than foreign tax credits motivate a U.S. business that engages in any other income-producing business transactions in a foreign jurisdiction that imposes an income tax.

XII. Conclusion

The BNY STARS Transaction had economic substance and achieved a core business purpose for a bank: it gave BNY the use of funds at a low cost and an opportunity to invest those funds to generate net interest income for five years. Respondent erred in denying Petitioner credits under section 901 for the U.K. income taxes owed and paid to obtain below-LIBOR financing through the BNY STARS Transaction. All of Respondent's other asserted adjustments in his notice of deficiency also are erroneous because they all are based on the faulty premise that the BNY STARS Transaction lacked economic substance and was a sham.

RESPECTFULLY SUBMITTED,

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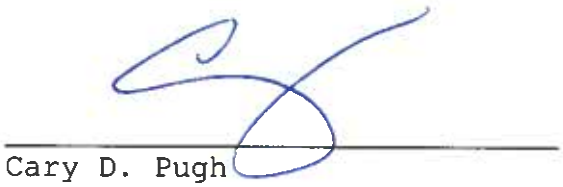
Date: March 27, 2012

CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing document entitled **PRETRIAL MEMORANDUM** was served on counsel for Respondent by delivering the same by electronic mail and private delivery service (Federal Express overnight) on March 27, 2012, addressed as follows:



Cary D. Pugh

Date: March 27, 2012